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ABSTRACT

In order to realize the full potential of this evolving information age and make its capabilities available to the greatest number of consumers, the telephone companies must be permitted to participate fully in the information and information-related markets. Indeed, a principal issue during this period of rapidly changing market conditions is the form and degree of regulation required in order for the consumers, the industry, and the general economy to receive optimum benefits. Recently, economic and social forces have combined to increase the importance of efficient telecommunications service to the nation's economy, while at the same time, the demand for telecommunications has expanded in the increasingly competitive global economy. However, market foreclosure, regulatory constraints, and economically inefficient pricing arrangements have hampered opportunities for competition, and the telephone companies have not been able to respond fully to the needs of the marketplace. As a result, the United States is no longer in the forefront in the provisioning of information services. Regulators have now begun to examine their impact on the U.S. telecommunications industry, however, and it is hoped that an altered regulatory process capable of providing more earnings and market flexibility will be adopted in the near future. (KM)

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THE INFORMATION AGE - LEADER OR FOLLOWER?

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Introduction

In recent years, the advancement of technology, significant governmental decisions, major changes in the structure of the marketplace and the entry and potential of competition in the telecommunications industry have fostered a whole new era of choices for customers and opportunities for service providers.

We believe that these changes will lead to a future of continued quality, convenient and reliable communications and information age services that will benefit all of society from individual households to the largest of corporations.

We have a vision of a fully enriched information age network. By this we in the industry mean capabilities or applications which typically combine three elements: software, hardware and network. Software provides the instructions to the machines involved; hardware refers to the machines and human interface devices; and the network is the transmission system which connects the hardware to other data, information, or communications sources.

Today, many of these applications are relatively limited. They are in use to some degree in certain industries, where typically only people trained in the development of software and hardware or use of computers have direct interaction. Although some applications have drastically changed industrial production and design and, therefore, indirectly affected large segments of the society, few applications have directly affected the general population. Nevertheless, at the present time, leading edge research is being conducted which would change this. For example, research in the areas of "voice recognition", "artificial intelligence" and "expert systems", combined with a continued downward slope of the "Cost/MIPS" curve, has the potential to bring information age applications to all segments of society.

In regard to the interconnection of the hardware, software and information sources, we envision a network which will allow anyone, at anytime, anywhere, to communicate easily and securely, in any medium or combination of media, whether voice, data, facsimile, image or video, at an affordable cost.

In addition to regular voice communications and sophisticated business solutions, technology can support new applications to home security for fire and burglar alarms, health monitoring systems for out-patient hospital services, home catalog shopping services, pay-per-view television ordering, access to information and database services, and many others. The potential is truly unlimited.

In order to realize the full potential of this evolving information age and make its capabilities available to the greatest number of consumers, we believe the telephone companies must be permitted to participate fully in the information and information-related markets. The telephone companies need to be able to focus on their customers and meet their needs for new products, increased efficiency and pricing arrangements that reflect marketplace and business considerations. The companies also need appropriate freedoms to research, develop and deploy new technology, services and capabilities and for coping with increased risks associated with operating in this environment.

At the same time, we believe that the customers of our less competitive services should be protected from any negative financial consequences that may result from our increased participation in those markets. It may be the continued role of regulation to provide this protection.

One of the principal issues we must wrestle with during this period of rapidly changing market conditions, is what form and what degree of regulation is appropriate. Is rate of return regulation the best means to regulate through this transitional period to fully competitive markets?

The purpose of this discussion is to continue to explore the nature of the current environment and to help establish a framework for discussion of the form and degree of regulation required in the current environment, so that in all respects, consumers, the industry, and the general economy benefit the most from the evolving information age.

Changes in the Marketplace

Significant changes in the structure of the marketplace have affected the demand for telecommunications services. Economic and social forces have combined to increase the importance of efficient telecommunications service to the nation's economy. The evolution of the U.S. toward a service economy provides a good example. Service-producing industries' share of the gross national product has increased 5% since 1972. Virtually all employment growth during that period occurred in service-related, non-manufacturing industries; 90% of the jobs created in the U.S. in the last decade were related to the creation, processing or manipulation of information. The growth of information-based jobs has increased business' dependence on innovative, reasonably priced telecommunications services.

We have also witnessed the development of an increasingly competitive, global economy. The automobile, electronics, textile and financial industries have all experienced the effects of international competition. The demand for telecommunications has increased in this environment. International data and voice transport continues to grow. Firms in these markets also seek new telecommunication and information services which provide more functionality and reduce overall cost, thus enhancing their ability to compete effectively against domestic and foreign rivals. Recognizing that information is the lifeblood of this global, competitive economy and that telecommunications is the network which keeps it moving, it is not surprising that these areas are also targeted for international competition. We believe, for example, that Japan has adopted an ambitious agenda to gain a world leadership position in the telecommunications equipment and service markets.

The Necessary Response

The importance of telecommunications to the economy and society is obvious. There are a number of activities we would naturally expect the telephone companies to focus on in response to changes in the marketplace. For example, given a clear need for new products and more cost effective arrangements, we would expect a continual flow of innovative services produced and provisioned through lower cost methods of production and implementation. We don't see this, however, in part because of the stultifying influence of market foreclosure and regulatory constraints.

When changes are made in this constraining environment, it's typically after a great deal of time has passed. Consumer benefits are distorted and delayed. Vigorous competition is never realized.

In regard to competition, because telecommunications growth has been so consistent and rapid and because new technology has lowered the costs of entry, one would expect the telephone companies to be facing stiff competition in more of their markets. However, due to a number of economically inefficient pricing arrangements, competition has been discouraged in some markets and artificially stimulated in others. As a result, it is very difficult to evaluate where competition is truly viable and where it is not.

The consequences of the telephone companies not responding fully to the needs of the marketplace are already apparent. Large financial and high-tech firms, those typically facing significant domestic or foreign competition, have sought out other sources for new services and greater efficiencies. Sometimes these firms, and other service industry related organizations such as hospitals or universities, have established their own telecommunication capabilities. In other instances, competitors who are subject to less regulation were selected.

Perhaps a more serious consequence is this nation's failure to be in the forefront in the provisioning of information services. In the last several months, due to Congressional hearings and news reports, many people have become aware of the fact that other nations have apparently moved ahead of us in terms of the availability of information services. France, in particular, has been highlighted for its advances in this area. Other countries, such as Japan, are also making significant investments in information services and transport capabilities. This may be a recognition by these nations of the importance of information services not only to their domestic and international economic positions but also in regard to meeting the needs of the general consumer.

Our nation should not fall behind the other post-industrial nations of the world in the development and deployment of information age services. Our auto and electronics industries serve as distressing examples of what could be repeated, perhaps with more negative consequences, in the information industry. We believe that to prevent this unnecessary outcome, the current method of regulation of the telephone companies should be altered.

In response to these fundamental competitive and economic changes, regulators have begun to examine their impact on the U.S. telecommunications industry. In some cases, entry barriers have been reduced for new participants. Federal and some state policy makers have also minimized traditional regulatory controls for new entrants. However, not enough has been done so far in all jurisdictions to alter the traditional regulation which restricts the market behavior of established carriers.

We have all observed dilemmas in the attempt to mix regulation and competition. Distortion typically occurs, for example, when regulation requires the local exchange carrier to price services above economic cost while entrants charge whatever they want. Rates are then inefficiently high and market segments are foreclosed. Telecommunications services are provided at higher cost than necessary and all customers bear the burden. At the same time, when the established carrier is forced to price some services below cost, competitive entry is discouraged, thus giving the established carrier a higher market share than may be consistent with minimizing output costs.

In our free enterprise economy, we rely on pricing signals to allocate resources, to stimulate investment and savings, to instigate innovation and to ensure the workability of supply and demand. Asymmetric rate of return regulation is impairing the smooth functioning of the telecommunications markets.

The changing competitive marketplace and the distortions created by the current rate base/rate of return regulation require that we seek regulatory reforms which will preserve those regulatory protections society feels are desirable, while eliminating those regulatory constraints that create the current economic distortions.

What Should We Do?

The present mixture of rate of return regulation and competition works against the production of the benefits expected of a competitive environment. Competition promotes economic efficiency and maximizes consumer welfare. Full competition cannot be achieved within the current regulatory environment. Nevertheless, we hope that in the near future we begin the transition through the adoption of altered regulatory processes which provide more earnings and market flexibility.

Earnings Flexibility

In the current environment, the risks associated with running the business are increasing. Competition is jeopardizing traditionally profitable revenue streams. At the same time, competition mandates significant R&D expenditures, long product lead times and uncertain future profits. Such higher risks translate into the need for more responsibility by management to deal with the consequences of its decisions.

More flexibility and more company responsibility for earnings is essential if the telephone companies are to compete vigorously and provide customers with a full range of service options. Alternative approaches to rate of return regulation which provide more earnings flexibility can better serve to protect ratepayers and also permit companies to effectively adapt to their rapidly changing environment.

Market Flexibility

We must be able to focus on our customers and respond to their needs. We must be able to respond quickly to changing market conditions by introducing new products and services and setting appropriate market prices for the new and existing services. Contract pricing, volume discounts, and market-based prices are examples of the types of price arrangements that are needed.

As technology and competitive services force more rapid product turn-over, the telephone companies will also have greater need to manage the life cycles of their product lines. Such product management is essential to deal effectively with such phenomena as customer willingness to pay, declining markets, obsolete technology and the introduction of new products. Given this environment, marketing flexibility is clearly needed if companies are to consistently meet market demands.

Conclusion

Through the realization of these freedoms, we'll bring regulation of the telephone industry in line with today's fast-changing technology and increasingly competitive marketplace without the cumbersome and obsolete baggage of the past. Indeed, freedom from the most onerous aspects of rate of return regulation will be essential to be able to deploy new technology in support of universal access to the information age for all customers.

At NYNEX, we have been voicing our concerns to regulators and political leaders at the federal as well as the state level, and we believe that our efforts have helped to focus more attention on this critical issue. Ours is not the only voice. The voices of the national and the world marketplace are being heard. We will continue to aggressively pursue all avenues in an effort to encourage further changes that will give us the freedom to use all of our resources to offer more choices to customers. As the industry moves forward from a regulated competitive environment, full utilization of our resources must be permitted in order to provide to our region and nation the full benefits of regulatory flexibility. Regulatory flexibility is America's best insurance against being second-rate in the information industry. And the public will benefit from these changes. Customers will be offered services which are lower-priced, more innovative and provide more options aligned with their needs. Reducing the stringency of regulation, where appropriate, will

have other benefits for the public. Not only will it reduce the amount of resources carriers spend on fulfilling their regulatory obligations, but it will also reduce the resources spent by the regulators. These benefits are a measure of the total social cost of continued regulation of any firm.

Changing the regulatory framework will probably happen only as a result of hard work by all of the parties involved. We can make a real contribution to our economy, an economy increasingly dependent on the telecommunications sector. Let's proceed boldly and vigorously.